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Central Intelligence Agency

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Washington, D.C. 20505

21 January 1983

MEMORANDUM FOR: Doug Hartwick, EB/IEP/EPC
Department of State

FROM : [redacted] Chief EURA/WE/BBC
Central Intelligence Agency 25X1

SUBJECT : US-Canadian Energy Consultative Mechanism

Attached is the background material you requested in preparation for the US-Canadian Energy Consultative Mechanism beginning 1 February 1983. It was prepared by [redacted] I regret that at this time we are unable to provide you with an advance copy of the NEP paper. Please feel free to direct any additional requests for information [redacted] to me at [redacted] 25X1 25X1 25X1

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Attachment:
as stated

EUR M83-10016

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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

21 January 1983

Canada: Slight Improvement in 1983 Petroleum Prospects

Summary

Although Canadian energy officials have recently begun to forecast a brighter future for the petroleum industry, activity should increase only moderately in 1983 because the industry is still suffering from the impact of the National Energy Program (NEP) and a soft world oil market. In 1982, drilling activity dropped 22 percent and production was off 3 percent from 1981 levels. Moreover, because of increased taxes and, in some instances, the high cost of borrowing to finance takeovers, many companies sharply curtailed investments last year. [redacted] 25X1

The slump in the petroleum industry may have bottomed out last summer. Oil exploration and production increased in the second half of 1982, probably as a result of incentives Alberta and Ottawa introduced in response to the precarious position of many firms in the industry. These incentives, however, ended in December 1982. Continuation of Canada's modest energy recovery, however, will depend on conditions in the world oil market and on future government energy policy. [redacted] 25X1

Impact of the National Energy Program

In October 1980, Prime Minister Trudeau introduced the National Energy Program (NEP) to achieve three primary goals: increasing the federal share of energy revenues, raising Canadian ownership and control of the petroleum industry, and achieving oil self-sufficiency by 1990. The NEP included 25X1

This memorandum was prepared by [redacted] Western European Division, Office of European Analysis. It was coordinated with the Office of Global Issues. Comments and questions are welcomed and should be addressed to [redacted] Chief West European Division, EURA, [redacted] 25X1

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several new taxes and set up a series of price schedules intended to bring Canadian oil prices closer to world levels. Prices of newly discovered oil and oil from enhanced recovery were raised to world levels, while the prices of "old" and "conventional" oil were scheduled to increase to a ceiling of 75 percent of world prices. The program also introduced special incentives to encourage Canadian ownership of the petroleum industry. 25X1

The Petroleum Incentive Program (PIP) was introduced with the NEP to encourage participation of Canadian companies in exploration of frontier areas. The PIP replaced depletion allowances with a series of federally funded grants covering from 25 percent to 80 percent of the costs of exploration. The size of the grant depends on the degree of Canadian ownership and control of individual oil companies. All companies operating on federal lands receive a minimum payment covering 25 percent of costs, with the total rising progressively with the percentage of Canadian ownership. 25X1

Ottawa has been partially successful in achieving the NEP's goals. Canadian ownership of the petroleum industry went from 28 percent in 1980 to 35 percent in 1982, and Ottawa garnered a much higher share of energy revenues over this period. Total federal oil and gas revenues ballooned from $1.8 billion in 1980 to $8.6 billion in 1982, primarily as a result of the NEP's Petroleum and Gas Revenue Tax (PGRT). Total government revenue from oil activity is expected to continue to rise -- albeit more slowly. 25X1

High taxes and regulated prices have cut sharply into petroleum industry revenues. The taxes contributed to a $1 billion decline in petroleum companies' 1981 net income from upstream operations -- exploration, development, and production. The Canadian Petroleum Agency estimates that the PGRT was responsible for three-fourths of the decline. For the first six months net income was down 54 percent from the same period a year earlier. 25X1

Reduced income in turn inhibited investment in energy exploration and development -- making it unlikely that Canada will be self-sufficient in oil by 1990. Although total capital expenditures for the first half of 1982 rose 7 percent, the gain was entirely due to a doubling of outlays for refining, marketing, and transportation, which obscured the decline in upstream expenditures. Canadian companies benefiting from the PIP increased exploration expenditures by 8 percent, but exploration outlays of foreign firms dropped nearly 21 percent. Overall drilling activity fell sharply as the number of wells completed dropped 21 percent from the 1981 level. 25X1

Petroleum production declined 3 percent in 1982 following a 11-percent dip in 1981. Figures for the first nine months of 1982 show output at 1.5 million barrels per day (b/d), a decline of 15 percent since the introduction of the NEP. 25X1

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Other Problems

The impact of the NEP has been compounded by soft world oil markets and the overall drop in economic activity in Canada. Soft world oil prices have kept "new oil" prices in Canada from rising as quickly as projected in the schedule outlined in the NEP. Some major operations such as the Alsands and Cold Lake synthetic oil projects were canceled as a result of reduced estimates of future world oil prices. In addition, high interest rates in 1981 and the first half of 1982 added to the costs of Canadian firms engaged in takeovers; much of the borrowing for the purchase of foreign-owned assets occurred at the time that interest rates peaked. [redacted] 25X1

New Energy Incentives

Reacting to the sharp drop in oil exploration and production, both Edmonton and Ottawa introduced packages designed to stimulate petroleum industry activities. Last April, Alberta implemented a four-year, $4.4 billion program, including an average cut in provincial royalties of about 5 percent. This program has already boosted industry revenues by $90 million. [redacted] 25X1

Alberta's incentives included a temporary $200 million program to aid the drilling industry. Although originally designed only to help finance well servicing, the program grew to cover almost 30 percent of the cost of drilling conventional oil and gas development wells. Despite requests from the drilling association to extend the program past its 31 December 1982 expiration date, it was allowed to expire. Alberta claimed to have achieved its goal of bringing temporary relief during a slow period. [redacted] 25X1

Stimulated by this program and by some new oil discoveries, drilling activity in Alberta did pick up significantly toward the end of 1982. More than 300 oil rigs were operating in November compared to summer levels of 80 to 90 rigs. With the end of Alberta's drilling incentives program, the number of working rigs probably will decline to about 200-250 for the rest of the winter. [redacted] 25X1

The federal government followed Alberta's lead with an industry incentive package of its own last June. Ottawa estimates that its program will return $1.6 billion to the industry through 1985. It includes:

-- A temporary reduction in the NEP's Petroleum and Gas Revenue Tax from 16 percent to 14.7 percent, bringing the effective rate down from 12 percent to 11 percent.
-- A C$250,000 credit toward the PGRT, designed to ease company cash flow problems. Small companies will be the prime beneficiaries of this credit.
-- An increase in July 1982 in the price of oil discovered after 1973 to 75 percent of world levels. This oil previously had been subject to provincial royalties at "new oil" rates even though it was not receiving the new oil reference price.

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-- The postponement until June 1983 of the new Incremental Oil Revenue Tax, which is applied to the additional revenue accruing to producers of "old oil" qualifying for prices above the "conventional old oil" price set in the NEP. 25X1

In addition, payment of PIP grants began last summer after implementing legislation was passed in July. Payments are retroactive to 1981, and Ottawa estimates that nearly $1.6 billion will be paid out for 1981 and 1982. Ottawa's 1982 review of the NEP projects the PIP's costs at $3.7 billion through 1985, although more recent estimates by the Energy Ministry put the figure at $7 billion. About 90 percent of the money will go to the small group of companies operating in the Beaufort Sea and off the east coast. 25X1

Another recent development was the replacement in September of Energy Minister Marc Lalonde by Jean Chretien; this move has done much to improve relations between the government and the petroleum industry. Chretien has a reputation as a compromiser, and he appears genuinely interested in helping the industry through the current difficult period. Thus far, his actions toward the petroleum industry have been much more conciliatory than Lalonde's. For example, Chretien has been very lenient in defining the types of oil qualifying for higher "new oil" prices. 25X1

Ottawa plans to extend customs jurisdiction from the current 12 mile limit to a distance of 200 miles or to the edge of the continental shelf -- whichever is greater. As a result, it will be able to levy duties on the equipment of foreign offshore drilling firms. Ottawa's intent is to end what it perceives to be the unfair advantage foreign companies have over domestic firms and to generate new business for Canadian suppliers. 25X1

Activity in Major Petroleum Areas

Nova Scotia

Energy officials have announced the discovery of a major natural gas field off the coast of Nova Scotia, in an area east of Sable Island known as Banqereau Banks. The field will be developed by a group of companies, with a view to exporting most of the gas to the northeastern United States. Development will be headed by Petro-Canada (the federally-owned oil company) and Nova Scotia Resources Limited (the province's oil corporation). Preliminary surveys indicate that the Banqereau reserve contains 3.1 trillion cubic feet (TCF) of natural gas, a total approximately equal to that of the much-publicized Venture Field 40 kilometers to the west. With the Banqereau discovery, Nova Scotia's total offshore natural gas reserves are now estimated to be about 7.9 TCF, one-half the estimated combined reserves of the Mackenzie Delta, Beaufort Sea, and High Arctic areas. 25X1

Mobil discovered a large natural gas field at Venture in 1979 and expects to find at least the 3 TCF necessary to assure production, but it cautions that at least one year of work is needed to prove the field is commercially viable. The Nova Scotia government and Mobil announced on 10 January the

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discovery of significant amounts of natural gas in two new fields to the west and southwest of Venture, although further drilling will be necessary to assess their production potential. The consortium headed by Mobil that is developing these fields requires export contracts and a transport system before beginning production. Mobil estimates production could begin in 1988 and is planning to start construction of an undersea pipeline in early 1984. [redacted] 25X1

The federal government is currently renegotiating oil exploration leases with companies operating off the east coast as required by the NEP. Ottawa hopes through this renegotiation to ensure that progress is made on developing the area. Mobil recently has agreed to drill more delineation wells at both Hibernia and Sable Island. Shell, another major developer, agreed this summer to spend $660 million exploring the Scotian shelf. Petro-Canada, Bow Valley, and Husky signed a similar exploration agreement in July worth $400 million. [redacted] 25X1

Companies involved in east coast exploration have complained of pressure from Ottawa and the provincial governments to speed development. If an exploration lease cannot be negotiated, the land reverts to the crown, increasing the pressure on companies to comply with federal wishes and possibly to proceed faster than is economically desirable. [redacted] 25X1

Newfoundland

Major oil and gas finds have been made off the coast of Newfoundland. The fields may hold up to 7.4 billion barrels of recoverable oil and 72 TCF of natural gas. Mobil's Hibernia field, discovered in 1979, is the most promising; oil from Hibernia was included in Canada's official reserve estimates for the first time in 1982. Production of the estimated 1.8 billion barrels of recoverable oil was originally scheduled to begin in 1986, but it has been delayed until 1989/90 by lack of a revenue-sharing agreement between Newfoundland and Ottawa. This delay has increased the projected cost of developing the Hibernia field to $5-6 billion at 1982 prices. Agreement over offshore ownership and revenue sharing is necessary before the area can be fully developed. Even if an offshore agreement is signed soon, most companies have already set their expenditure programs for 1983 and have little excess cash to put toward increased exploration. [redacted] 25X1

Beaufort and Arctic

Estimates of potential oil and gas reserves in the Canadian Beaufort Sea vary widely. A February 1982 projection by the Royal Bank of Canada put recoverable reserves at 9.4 billion barrels of oil and 112 TCF of gas; while Esso has estimated oil reserves at 6-10 billion barrels and gas reserves at only 8 TCF. Actually discovered oil reserves are currently put at 200 million barrels by the Royal Bank. [redacted] 25X1

Some operators in the Beaufort Sea initially were optimistic about future development -- in spite of the NEP -- because of the likelihood of large

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discoveries. However, the massive investment in new technology required to achieve production, combined with the outlook for a weak oil market at least until 1985, has recently dampened enthusiasm. For example, Gulf Petroleum -- a major developer in the Beaufort Sea with total projected expenditures of $2 billion through the 1980s -- has considered selling Gulf Canada but has been unable to find a buyer. [redacted] 25X1

Gulf's latest delineation of the Tarsiut fields in the Beaufort Sea did not find them to be of commercial size. Moreover, Gulf has recently announced plans to cut expenditures in northern Canada, citing excessive costs in developing the area. Several small Canadian companies involved in the Panarctic group have been forced to withdraw from the region because the cost of exploration was too high, and Dome Petroleum, one of the largest players in the area, is in such a shaky financial state that future development is uncertain. Dome has not yet cut back its activity, but the company is having extreme difficulty financing its operations. [redacted] 25X1

Outlook for 1983

Any increase in petroleum activity this year is likely to be slight. Some analysts recently have been predicting a bright year for the oil and gas industry in Canada, but we believe that recovery will be slowed by the soft world oil market and the re-instatement of some of the NEP's taxes. Although new incentives and the beginning of PIP payments eased the industry's cash flow problems in 1982, many companies still finished the year with devastated balance sheets and will be unable to embark on ambitious programs of exploration and development. New cash flow likely will be used for debt retirement. Moreover, the incentives appear insufficient to support the long-term, expensive exploration activity needed to boost the industry. Foreign-owned companies -- those in the best position to engage in exploration activity -- are discriminated against in the PIP grant system. [redacted] 25X1

Production is projected to increase by about 7 percent to 1.6 million b/d in 1983, and drilling probably will increase by 10 percent, aided at first by Alberta's incentives. The flow of oil rigs to the United States has been stemmed, but much of the Canadian rig fleet will remain inactive throughout the year. Moreover, provincial land sales -- an indicator of future activity -- are still slumping. [redacted] 25X1

Most of Ottawa's tax benefits will be absorbed before the end of 1983. The incentives have provided needed cash to the industry, enabling some companies to survive in 1982, but the record-high interest rates led to vastly increased debt service payments for many of the smaller Canadian oil companies. These companies are still preoccupied with reducing their debt, and they are not in a position to significantly increase their exploration and development activity. [redacted] 25X1

The January 1983 wellhead price increase of C$4.00 per barrel will help industry cash flows. However, with the NEP continuing and with predictions

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that world prices will remain weak, the increases scheduled for July may not occur because domestic oil prices may reach their ceiling of 75 percent of the world price. In addition, the taxes reduced or delayed by Ottawa last year are scheduled to be reintroduced in June. [redacted] 25X1

Another cloud on the horizon is concern by investment analysts, industry officials, and even some government officials that Ottawa will be unable to finance PIP and may be forced to reduce grant payments in the future. This concern may lead firms to hold back on large investment activities. Energy Minister Jean Chretien and his predecessor Marc Lalonde, however, have repeatedly assured the energy industry that PIP will not be modified because of cost. Chretien has stated that the program is an essential element in Canadianization and that expenditures for it are an important indication of progress toward energy security. Ottawa has stressed the importance of the exploration incentive program and would be reluctant to drop its grants. We expect exploration to proceed slowly throughout the next five years, holding down the cost of PIP and enabling Ottawa to continue the program. [redacted] 25X1

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